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Report to the Secretary of Defense

April 1993

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ARMY INVENTORY

Current Operating and
War Reserve
Requirements Can Be
Reduced



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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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April 14, 1993

The Honorable Les Aspin
The Secretary of Defense

Dear Mr. Secretary:

This report discusses the Army's efforts to reduce its requirements for secondary items categorized as being needed to meet current operating and war reserve requirements. Our objectives were to determine what additional actions the Army needs to take to reduce its secondary items inventory requirements because of the changes in threat, reduced force structure, and the likely type of conflicts the Army may face in the future.

The results of our review are summarized below and discussed in more detail in appendixes I through IV. Our scope and methodology are discussed in appendix V.

Background

DATA SECURITY UNPAGED 5

Over the past 3 years, the Army has reduced its requirements for spare parts that are needed to meet current operating and war reserve requirements, called authorized force acquisition objective, about \$10 billion—from \$37 billion to \$27.3 billion. The \$10-billion reduction resulted from the Army's decision that a changed threat environment and reduced force structure would reduce the inventory required. Appendix I summarizes the efforts taken by the Army to reduce its current operating and war reserve requirements.

Results in Brief

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CRA&I	<input type="checkbox"/>
DTIC	<input type="checkbox"/>
TAB	<input type="checkbox"/>
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Although the Army has made progress in reducing its requirements for secondary items, its current operating and war reserve requirements remain significantly overstated. At the Aviation Systems Command and Tank-Automotive Command, the requirements for inventory needed to meet current operating and war reserve needs were overstated by at least \$1.6 billion. As a result, unnecessary repair programs, costing several million dollars, were established and unnecessary procurements could have occurred.

At the two commands, for example:

- War reserve requirements are overstated by at least \$500 million because the requirements have not been updated and continue to be based on a

European war scenario. In turn, these overstated requirements resulted in unnecessary repair programs and potentially could have caused unnecessary procurements.

- The current operating requirements are overstated by at least \$31 million because these requirements include items due in on contracts that were uneconomical to terminate.
- The current operating requirements are overstated by about \$1 billion because the demand data bases that are used to forecast future requirements include nonrecurring demands but do not reflect the return of serviceable items from field units.

The systems and policies being used by the Tank-Automotive Command and the Aviation Systems Command for forecasting requirements are also being used by the other four national inventory control points. Therefore, the types of overstated requirements that we found could also be occurring at the other four national inventory control points and, on an Army-wide basis, the requirements could be overstated by several billion dollars.

War Reserve Requirements Are Outdated and Overstated

From March 1989 through June 1992, the requirements for funded war reserves at the Tank-Automotive Command increased from \$264 million to \$470 million and at the Aviation Systems Command, from \$324 million to \$359 million. The increases occurred, in part, because Army policy allowed national inventory control points to increase the funded war reserve requirements by transferring excess inventory assets to the funded portion of the war reserve requirement. By doing so, the Army increased the requirements objective and avoided possible disposal action.

The overstated war reserve requirements and the overstated requirements objectives resulted in unnecessary repair programs being established and could cause unneeded procurements to be made. At the Tank-Automotive Command, we found that repair programs, costing about \$4 million, were established because of overstated war reserve requirements.

Tank-Automotive Command officials told us that the Army is revising its war reserve requirements to reflect the current threat and force structure, and the Army believes the new requirements should be about 60 percent less than the current requirements. Based on this revision, the funded war reserve requirements at the Tank-Automotive Command and the Aviation Systems Command are overstated by about \$500 million.

In addition to revising its war reserve requirements, the Department of Defense (DOD) issued instructions in September 1991 that directed the services to include in the funded portion of the war reserve requirements only those items acquired with funds appropriated by the Congress for that purpose.

At the time we completed our review in September 1992, the Tank-Automotive Command had not taken action to reduce the funded war reserve requirements by eliminating those items that had been transferred from unneeded inventory. Therefore, while the funded portion may not increase in the future, the existing funded war reserve requirements are still overstated and could continue to influence repair program and procurement decisions.

In commenting on a draft of this report, DOD officials said that at the time we completed our review, the war reserve requirements did not reflect the changes to the threat and force structure. They also said that Army major commands are recomputing their war reserve requirements and initial indications are that the requirements will be reduced \$6 billion—from \$10.2 billion to \$4.2 billion. The Army expects to complete its evaluation in June 1993.

Special Purchases Caused Requirements Objectives to Be Overstated

Army policy allows the national inventory control points to increase their requirements objectives by including inventory items procured through life-of-type buys and quantity discounts.¹ The Army, however, has expanded the use of this policy to include items due in on contracts that were uneconomical to terminate or reduce.

This policy change occurred in April 1987 when the Army Materiel Command advised the national inventory control points that the growing levels of inventory items not needed to meet current operating and war reserve requirements represented an unacceptable trend. The Command further advised that when it is uneconomical to cancel or reduce a contract, the items should be included as part of the requirements objective. We found that the requirements objectives were overstated by \$21 million at the Tank-Automotive Command and \$10 million at the Aviation Systems Command as a result of following this policy.

¹Life-of-type buys are those situations where the item is going out of production. Quantity discount buys are procurements above the normal economic order quantity that take advantage of price discounts.

Including the due-in items in the requirements objectives do not affect repair program or procurement decisions because the requirements objective is reduced as the items are received. However, including the due-in items in the requirements objectives gives the appearance that items not needed for current operating requirements are needed.

Additionally, a decision that it is uneconomical to terminate or reduce a contract is essentially the definition of economic retention inventory—inventory that is not needed to meet current operating and war reserve requirements but is more economical to retain than to dispose of and reprocure at a later date.

DOD officials, in commenting on a draft of this report, agreed that items due in on contracts that are uneconomical to terminate are included in the extended requirements objectives. The officials, however, did not agree that including these items inflates the requirements objective. They maintain that because the items are due in, and not physically on hand, they would not be counted against the requirements objective or considered as economic retention until the items are received. At that time, the extended requirements objective would be reduced and the items could be considered as economic retention inventory.

Our review showed that the items due in do increase the requirements objective. As a result, at any point in time, the requirements objectives are inflated by the amount of due-in items included as extended requirements objective requirements. We believe that the items due in from contracts not economical to terminate should not be shown as part of the requirement needed to meet current operations. Instead, the items should be categorized as economic retention inventory.

Overstated Demands Contribute to Excess Inventory

The demand data bases used to forecast requirements consist primarily of recurring demands, which are defined as repetitive requests for materiel. However, both the Tank-Automotive Command and the Aviation Systems Command include all nonrecurring demands in their demand data bases. The Army's rationale is that nonrecurring demands at a unit are repetitive on an Army-wide basis and, therefore, are recurring.

Between July 1991 and June 1992, the Tank-Automotive Command and the Aviation Systems Command included nonrecurring demands valued at \$100 million and \$410 million, respectively, in their demand data bases. These nonrecurring demands equated to increased requirements of about

\$200 million at the Tank-Automotive Command and \$819 million at the Aviation Systems Command.

While all the national inventory control points currently include nonrecurring demands in their demand data bases, this has not always been the case. Until November 1991, the Missile Command did not include nonrecurring demands because, according to a Command official, to do so would inflate demand levels and would cause inaccuracies in requirements and the number of items not needed to meet operating and war reserve requirements.

Including nonrecurring demands in the demand forecasting process also is questionable because:

- The requirements determination process already includes a safety-level requirement that is intended to allow for unanticipated demands, such as nonrecurring demands.
- Retail-level activities are precluded by Army regulations from including nonrecurring demands in their requirements computations because wholesale-level requirements are a reflection of retail-level demands.

Additionally, the Army Materiel Command, in September 1990, questioned the policy of including nonrecurring demands in the demand data base. In this case, they would be counted as recurring demands and could result in unnecessary procurements by the wholesale system.

DOD officials, in commenting on a draft of this report, agreed that caution should be used before including nonrecurring demands in the demand data base. They said that guidance dated January 1993 provides that nonrecurring demands should be included in the demand data base only if the item manager can demonstrate that doing so will improve the item forecast.

All Serviceable Returns Are Not Offset Against Demands

DOD's policy provides that when customer demands are used as a basis for forecasting future requirements, demand data should be adjusted to reflect the return of serviceable items.

The Tank-Automotive Command and the Aviation Systems Command do not perform an item-by-item analysis to determine whether to offset the demand data by the return. Instead, the commands use an offset limit equal to 50 percent of demands as the basis for adjusting their demand

data bases. For example, if there were 100 demands for an item and there were 60 serviceable returns, the commands would reduce the demands by 50 even though 60 items were returned. Command officials told us that systemic deficiencies in their data systems preclude them from managing serviceable returns on an item-by-item basis.

We selected 15 items at the Tank-Automotive Command and performed an item-by-item analysis. The 15 items had 1,416 serviceable returns, valued at \$2.6 million, that were not offset against demands because the number of returns exceeded the 50-percent limit.

The DOD Inspector General and our office have previously issued reports² on the Army's practice of not adjusting the demand base to reflect all serviceable returns. Nevertheless, the Army continues to use the 50-percent offset limit rather than perform an item-by-item analysis as recommended in the reports and required by DOD directives.

In commenting on a draft of this report, DOD officials said that the use of the 50-percent offset was based on the extensive manual effort required to do an item-by-item analysis. They further stated that the Army is now reviewing its method of treating serviceable returns to ensure that an overstatement of requirements objective does not occur.

Recommendations

We recommend that the Secretary of the Army direct the Commander, Army Materiel Command, to

- establish war reserve requirements based on the latest Army strategy and doctrine giving consideration to the new threat, reduced force structure, and probable type of conflicts the Army can expect in the future;
- transfer inventory that is no longer needed to meet the revised war reserve requirements to retention-level inventory or send it to disposal;
- recategorize as economic retention-level inventory those items that are being retained as part of the requirements objective because the associated contracts are uneconomical to terminate;
- process inventory items that do not qualify for economic retention for disposal;

²Army Can Save Millions Annually by Properly Considering Serviceable Returns in its Requirements Computations (LCD-80-64, May 15, 1980) and The Army's Use of Serviceable Returns in Requirements Computations (GAO/NSIAD-85-59, Apr. 9, 1986).

Report on the Audit of Military Department Requirements for Currently Procured Wholesale Inventories of Consumable Items (Report No. 91-106, June 28, 1991).

- discontinue the practice of including nonrecurring demands as part of the demand data base used to forecast spare parts requirements; and
- begin offsetting all serviceable returns against demands unless an item-by-item analysis shows that systemic deficiencies preclude serviceable returns from being offset against demands. In such cases, the national inventory control point should identify the systemic deficiencies and develop a corrective action plan for resolving the deficiencies.

Agency Comments

DOD generally concurred with our recommendations. DOD officials pointed out that at the time of our review, the war reserve requirements had not been recomputed to reflect the change in threat and force structure. They went on to say that the Army is in the process of recomputing its war reserve requirements and initial indications are that the requirements will be reduced from \$10.2 billion to \$4.2 billion—a reduction of \$6 billion. The officials also stated that inventory not needed to meet the war reserve requirements or economic retention and contingency retention levels would be classified as potential reutilization (potential excess) inventory in accordance with DOD policy.

The officials agreed that items due in on contracts not economical to terminate are included in the extended requirements objectives. However, the officials said that because the items are in a due-in status, they do not increase the requirements objectives and that when the items are received, the items could be considered as economic retention inventory.

As our review showed, the due-in items inflate the requirements objective and show a larger requirements objective than is actually needed. This, in turn, prevented inventory from being disposed of. Therefore, our position remains that the due-in items should not be included in the requirements objective but should be categorized as economic retention inventory.

DOD agreed that caution is needed before including nonrecurring demands in the demand data base. In this regard, the officials said that the January 1993 DOD Materiel Management Regulation limits the quantity of nonrecurring demands included in the demand data base to those that items managers can demonstrate will improve the demand forecast.

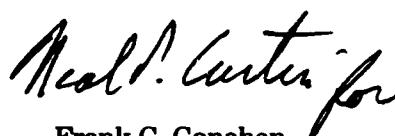
With regard to serviceable returns, DOD officials said the Army is reviewing its method for offsetting serviceable returns against demands and that the results of its review will be implemented by June 1994. The officials also said that the Army will issue guidance to its inventory control points by

June 15, 1993, to review serviceable return rates on an item-by-item basis when it is economical.

We are sending copies of this report to the Chairmen of the House Committee on Government Operations, Senate Committee on Governmental Affairs, and the House and Senate Committees on Armed Services and Appropriations; the Secretary of Defense; and the Director, Office of Management and Budget.

This report was prepared under the direction of Henry L. Hinton, Jr. If you or your staff have any questions concerning this report, please contact him at (202) 512-4126. Other major contributors to this report are listed in appendix VII.

Sincerely yours,



Frank C. Conahan
Assistant Comptroller General

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Abbreviations

AFAO	approved force acquisition objective
AVSCOM	Aviation Systems Command
DOD	Department of Defense
EXTRO	extended requirements objective
TACOM	Tank-Automotive Command

Army's Efforts to Reduce Its Current Operating and War Reserve Requirements for Secondary Items

The Army's current operating and war reserve needs are referred to as the approved force acquisition objective (AFAO). In general, the AFAO represents the Army's future needs during the next 24 to 36 months and consists of various requirements levels, including the following:

- War reserves are the items needed to replace combat equipment losses after a war starts. The total war reserve requirement consists of "protectable war reserves" and "balance-war reserves." Protectable war reserves, also referred to as funded war reserves, are part of the total requirement that has been funded by Congress, but the inventory is not available for general issue except for such situations as to solve nonoperational equipment problems. The balance-war reserves are part of the total requirement that has not been funded. Both parts of the war reserve requirement are included in the AFAO. However, whereas the funded portion of the requirement is part of the requirements objective¹ and is considered in making procurement and repair decisions, the unfunded portion of the requirement is not.
- Demands represent the inventory requirement that is forecasted as being needed during the period covered by the AFAO.
- Safety level represents the inventory requirement that is needed in the event of unanticipated delays in receiving ordered materiel or unanticipated increases in demands.
- Administrative and production lead times are the inventory requirements needed to meet operational needs from the time an order is initiated until the ordered items are received.
- Repair cycle time represents the inventory requirement needed to meet operational needs during the time it takes to ready unserviceable items for issue.
- Reorder cycle time represents the inventory requirement needed to meet the economic order quantity, that is, the requirement level that optimizes the cost of holding inventory versus the cost of placing a procurement order.

From September 1989 to June 1992, the Army decreased its AFAO requirements for spare parts from \$37.0 billion to \$27.3 billion—a reduction of \$9.8 billion. At the two national inventory control points in our review, the AFAO requirements were reduced from \$11.2 billion to \$9.3 billion at the Aviation Systems Command (AVSCOM) and from \$8.2 billion to \$5.2 billion at the Tank-Automotive Command (TACOM).

¹The requirements objective is comprised of administrative and procurement lead times, safety level, war reserve, and procurement cycle requirements. The sum of these requirements levels and the balance of the war reserve requirement (unfunded portion) is the AFAO.

Appendix I
Army's Efforts to Reduce Its Current
Operating and War Reserve Requirements
for Secondary Items

The AFAO reductions resulted from the Army's decision to decrease its force structure because of the changes in the world situation. The decreased AFAO requirements generally occurred in the requirements levels for administrative lead time, production lead time, reorder cycle time, and safety levels. However, at the same time the Army reduced these requirements levels, it increased other requirements levels, such as the protectable (funded) war reserves level.

Table I.1 shows the changes in the AFAO requirements levels on an Army-wide basis and for the two national inventory control points included in our review.

Table I.1: Changes in the AFAO Requirements Levels (September 1989 and June 1992)

Dollars in millions

Requirements levels	Army-wide		TACOM		AVSCOM	
	9/89	6/92	9/89	6/92	9/89	6/92
Protectable war reserves	\$1,115	\$1,483	\$264	\$470	\$324	\$359
Stock due out	1,725	864	637	228	365	180
Demands	13,861	12,258	3,295	2,621	4,671	4,377
Safety level	1,739	807	368	105	461	293
Numeric stock objective	83	66	5	2	18	7
Repair cycle	1,003	972	178	121	434	489
Production lead time	4,623	2,757	988	524	1,422	1,060
Administrative lead time	3,141	1,850	667	396	991	637
Reorder cycle time	2,395	1,449	700	362	532	392
Balance AFAO	169	169	23	2	69	84
Balance-war reserves	7,193	4,584	1,093	344	1,867	1,377
Total	\$37,047	\$27,259	\$8,218	\$5,175	\$11,154	\$9,255

The Army achieved the reduced inventory requirements levels by

- establishing inventory buy reductions ranging from 10 percent to 25 percent, depending on whether the items were essential or nonessential consumables or reparables;
- establishing a maximum safety-level requirement of 12 months for nonessential items and 24 months for essential items;
- limiting the demand base to 12 months of demands in order to exclude the large number of demands recorded during Operation Desert Storm;
- establishing a maximum reorder cycle of 12 months for nonessential items in order to reduce the amount of inventory procured at one time;

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- reducing from 100 percent to 90 percent the percentage of nonrecurring demands included in the historical demand base; and
- increasing the percentage of demands, from 20 percent to 50 percent, that could be offset by serviceable returns in order to reduce the historical demand base used to forecast requirements.

War Reserve Requirements Are Overstated

War reserve requirements at TACOM and AVSCOM continue to be based on the European scenario of an all-out land war with the Soviet Union. The national inventory control points plan to revise the requirements to reflect the changed Soviet threat, reduced force structure, and types of conflicts expected in the future. The requirements should be decreased significantly—an estimated 60 percent, according to Army officials. In the interim, however, the requirements are overstated by \$500 million.

The overstated war reserve requirements led to unnecessary repair programs totaling \$4 million at TACOM; could have caused unnecessary procurements; and masked unneeded inventory as being needed to meet current requirements.

Requirements Not Adjusted to Reflect Current World Situations

From March 1989 through June 1992, the funded war reserve requirements increased from \$1.1 billion to \$1.5 billion on an Army-wide basis. The funded war reserve requirements increased from \$264 million to \$470 million at TACOM and from \$324 million to \$359 million at AVSCOM. These increased requirements have resulted in unnecessary repair programs and the retention of inventory that is excess to current requirements.

In commenting on a draft of this report, DOD officials said that at the time we completed our review, the war reserve requirements were outdated because the requirements did not reflect the changes to the threat and force structure. They also said that Army major commands are recomputing their war reserve requirements and expect that the requirements will be reduced by \$6 billion—from \$10.2 billion to \$4.2 billion. The recomputation process should be completed by June 1993.

As part of the Army's inventory reduction program, the Army Materiel Command issued instructions to the national inventory control points in July 1992 to reduce the funded portion of the war reserves requirements by 50 percent. Our analysis showed, however, that the total war reserve requirements will not be changed because only the funded portion of the requirements will be reduced and the unfunded portion will be increased. Until the total war reserve requirements are revised to reflect the current world situation, the requirements will remain overstated and excess inventory will be maintained as part of the AFAO.

Overstated Requirements Caused Unnecessary Repair Programs

Before September 1991, DOD policy provided that inventory that exceeded the AFAO requirement could be added to the funded war reserve portion of the requirements objective. When inventory is below the requirements objective, a decision is made whether to buy additional inventory or repair unserviceable inventory.

At TACOM, we identified three cases where the decision to establish repair programs, valued at \$4 million, resulted from war reserve requirements being increased to accommodate inventory that should have been transferred to retention or disposal. For example, in March 1990, TACOM increased the funded war reserve requirement for the transmission used on the M113 personnel carrier by 1,091 items (from 97 to 1,188) due to inventory that exceeded the AFAO. Because of the revised requirements objective, the number of serviceable transmissions was not sufficient to meet the revised requirement. To compensate for the shortfall, TACOM decided to repair 503 unserviceable transmissions at a cost of \$1.2 million.

In March 1991, the DOD Inspector General issued a report¹ on DOD's policy of transferring excess inventory to the funded war reserve requirement. As a result of the report, DOD rescinded its policy in September 1991. DOD advised the national inventory control points that it could no longer justify the practice of transferring inventory to funded war reserves because these items were to only be acquired with funds appropriated by Congress for that specific purpose. DOD incorporated this policy in its draft Management Regulation, dated May 1992, which provides that only war reserve stocks acquired with direct appropriations may be considered in the funded portion of the war reserve requirement.

TACOM, however, has not taken action to reduce its funded war reserve requirements by eliminating those items that had previously been transferred in. Therefore, while the funded portion may not be increased in the future, the national inventory control points could institute additional unnecessary repair programs or procure items to meet the inflated requirements.

¹Final Quick-Reaction Report on Budgeting for War Reserve Stocks in the Defense Logistic Agency (Report No. 91-066, Mar. 4, 1991).

Special Purchases Cause Requirements Objectives to Be Overstated

Army policy allows the national inventory control points to increase AFAO for life-of-type buys and quantity discounts.¹ The increased requirements objectives are referred to as the extended requirements objective (EXTRO).

The Army has expanded the intent of EXTRO to include items due in on contracts that are not economical to terminate or reduce. This expansion increases the AFAO requirements level and protects inventory from possible disposal actions. As of September 30, 1992, the Army reported EXTRO requirements of \$808 million. We could not determine on an Army-wide basis what portion of these requirements related to other than life-of-type buys and quantity discount buys. We found, however, that the requirements objectives were overstated by at least \$21 million at TACOM and \$10 million at AVSCOM due to contracts that were uneconomical to terminate.

EXTRO Is Being Used for Purposes Other Than Specified by Army Policy

The intended use of EXTRO was to enable the national inventory control points to increase their requirements objective to procure life-of-type buys and quantity discount buys. In April 1987, the Army Materiel Command expanded the use of EXTRO when it notified the national inventory control points that the growing levels of inventory items not needed to meet current operating and war reserve requirements represented an unacceptable trend. It also said that when canceling a contract is uneconomical, EXTRO should be used to account for the assets that exceed the requirements objective rather than accounting for them by artificially inflated demands.

Our review showed that EXTRO is being used for situations other than life-of-type or quantity discount buys. Of the \$125 million of these requirements at TACOM, we reviewed items valued at \$84 million and found that \$21 million of the items did not qualify as life-of-type or quantity discount buys. For example, in September 1991, TACOM contracted for 926 axial pump assemblies (valued at \$4 million) for the M1 tank. After the contract was awarded but before the pumps were delivered, projected requirements decreased. In December 1991, TACOM determined that it was not economical to reduce or terminate the procurement and approved 173 pumps for EXTRO in January 1992. Although TACOM's April 1992 analysis of projected requirements showed a decrease in requirements, it increased EXTRO to 926 pumps.

¹EXTRO does not affect procurement and repair decisions even though it increases the requirements objective and AFAO. The reason for this is that as EXTRO inventory is issued, the requirement is reduced until it reaches zero.

Prior to our visit to AVSCOM in July 1992, the Command eliminated \$101 million worth of EXTRO requirements that did not meet the criteria. Notwithstanding this action, we found that \$10 million of the Command's remaining \$38 million of EXTRO requirements did not qualify as life-of-type or quantity discount buys. Instead, the requirements were for items due in on contracts that were uneconomical to reduce or terminate. In addition, there was insufficient information available for us to determine whether another \$24 million of the \$38 million of EXTRO requirements met the criteria.

A decision that it is uneconomical to terminate or reduce a contract is a de facto decision that it is economical to retain the items. This is essentially the definition of economic retention inventory—inventory that is not needed to meet current operating and war reserve requirements but is more economical to retain than to dispose of and reprocure at a later date. Therefore, items due in on contracts that are uneconomical to terminate should also be considered as part of economic retention.

Overstated Demands Contribute to Excess Inventory

The demand data bases at TACOM and AVSCOM do not accurately reflect the demand rates because the data bases (1) include nonrecurring demands and (2) do not reflect the return of serviceable assets from field units. These two data sets resulted in overstated requirements of at least \$1 billion at the two national inventory control points. Additionally, the overstated requirements have the potential for causing unnecessary procurements.

Nonrecurring Demands Cause Overstated Requirements

Historical demands are an integral part in forecasting spare parts requirements. Although the demand data base consists primarily of recurring demands, both TACOM and AVSCOM include all nonrecurring demands. The Army defines nonrecurring demands as requests known to be a one-time occurrence and nonrepetitive.

The Army's rationale for including nonrecurring demands in its demand base is that, from an overall prospective, nonrecurring demands become repetitive and recurring in nature. In other words, during each reporting period, there are nonrecurring demands. Therefore, the recurring nature of nonrecurring demands make the demands repetitive.

Between July 1991 and June 1992, AVSCOM included nonrecurring demands valued at \$410 million, and TACOM included nonrecurring demands valued at \$100 million. Based on an AFAO period of 24 months, nonrecurring demands equated to increased requirements of about \$819 million at AVSCOM and \$200 million at TACOM.

One example illustrates the effect of including nonrecurring demands in the data base. From June 1991 through June 1992, there were 178 demands for an oil pump assembly (unit price of \$5,814) used on the M1 tank.¹ The total demands included 29 nonrecurring demands, and the average monthly demand, including nonrecurring demands, was 14.8. Including nonrecurring demands in the demand data base increased the average monthly demand from 12.4 to 14.8. Based on an AFAO period of 24 months, the requirements increased by 57 items—\$331,398—as a result of including the nonrecurring demands.

The Army's position of including nonrecurring demands is not supported by studies or analyses. In fact, the Army Materiel Command, in September 1990, questioned the policy of including nonrecurring demands

¹This example relates to demands in only one theater and one service. It does not consider other factors that could affect requirements such as vehicle densities and serviceable returns.

in the demand data base. The Command advised the national inventory control points that nonrecurring demands should be coded as such. Otherwise, the demands would be counted as recurring demands and could result in unnecessary procurements by the wholesale system. Subsequently, in July 1991, the Army Materiel Command issued a memorandum to the national inventory control points that stated the decision to include nonrecurring demands at 100 percent was being challenged as part of the Army's Inventory Reduction Program. The memorandum went on to say that before a decision is made whether to continue to count nonrecurring demands, the Army Materiel Systems Analysis Activity-Inventory Research Office would review the matter. At the time we completed our review, the Inventory Research Office had not begun its review.

All of the national inventory control points are now following the policy for including all nonrecurring demands. In the past, however, this was not so. An Army Missile Command official said that the decision not to include any nonrecurring demands in its demand base was made by the Material Management Director in September 1989. At that time, the director advised the Army Materiel Command that including all nonrecurring demands in requirements computations inflates demand levels and would cause inaccuracies in requirements and the asset position for items not needed to meet operating and war reserve requirements.

The DOD Inspector General has also reviewed the issue of whether nonrecurring demands should be considered in forecasting requirements. The report, which was issued on October 8, 1991, pointed out that the services and the Defense Logistics Agency were inconsistent in how they treated nonrecurring demands to forecast requirements. The Army and Defense Logistics Agency included nonrecurring demands in their forecasts, and the Navy did not include nonrecurring demands. The Air Force has not included nonrecurring demands for consumable items since May 1988, but prior to then included all nonrecurring demands in its forecasted requirements. The Air Force, in deciding not to include nonrecurring demands in its demand forecasting process, was concerned that by including nonrecurring demands, inventory not needed to meet current operating and war reserve requirements would increase.

Our review also identified other reasons why nonrecurring demands should not be included.

- The requirements determination process includes a safety-level requirement that provides for unanticipated demands.
- Retail-level activities are precluded by Army regulations from including nonrecurring demands in their requirements computations. Because the wholesale-level requirements are a reflection of retail-level demands, it is inconsistent that the wholesale-level would include nonrecurring demands in its requirements determination process.

Serviceable Returns Are Not Offset Against Demands

DOD's policy provides that when customer demands are used as a basis for forecasting future requirements, demand data should be reduced to reflect the return of serviceable assets. The rationale for the policy is that the nature of the return often makes the original demand inappropriate for use in forecasting. The policy further states that returns should be used as a basis for adjusting future demands on an item-by-item basis, not on across-the-board averages or as a percentage of demands.

An exception to the item-by-item analysis is allowed when systemic deficiencies preclude obtaining the information necessary for making such an analysis. DOD officials consider a systemic deficiency to be where an item manager lacks detailed information about the return and, therefore, cannot make an item-by-item analysis.² In such cases, DOD policy allows the agency to request a waiver and use a percentage of demands until the systemic deficiencies are corrected.

TACOM and AVSCOM use 50 percent of demands as the offset limit for serviceable returns. Command officials told us that their data systems do not allow them to relate the return of a specific serviceable asset to the date the item was demanded. Therefore, item managers cannot determine the reasons for the serviceable returns and whether the returns should be offset against demands.

Our review showed that, contrary to DOD policy, neither command had requested a waiver because of the systemic deficiencies nor had they developed a plan to correct the deficiencies. Additionally, an Army Materiel Command official told us that, with proper training, item managers could determine if returns should be offset against demands.

For the year ending June 30, 1992, TACOM and AVSCOM had serviceable returns of \$394 million and \$742 million, respectively. We could not

²A reason for not offsetting the serviceable returns against the demand data base would be those cases where the demand for the items being returned occurred during a period that is not covered by the demand data base.

determine the extent that the total serviceable returns were offset against demands because information was not readily available. We selected a sample of 15 items at TACOM and found that there were 1,416 serviceable returns, valued at \$2.6 million, that were not offset against demands. In one case, for the 1-year period ending August 30, 1992, there were 254 demands³ for an oil pump assembly (unit price of \$1,390) used on a 5-ton truck. During the same period, serviceable returns of the item totaled 147. Based on a theater-by-theater analysis, using the 50-percent offset limit, 20 serviceable returns were not offset against demands and requirements were increased by \$58,380.

Until July 1992, the offset limit was 20 percent based on a May 1987 Army Inventory Research Office study. The 1987 study recommended that when returns exceeded 20 percent, an item-by-item analysis should be performed to determine if a larger offset was warranted. In July 1992, the Army Materiel Command, as part of its Inventory Reduction Plan, issued instructions to its national inventory control points that allowed them to establish a serviceable return offset limit equal to 50 percent of demands.⁴ The instruction also allowed them to use a higher offset limit if it could be justified on an item-by-item basis.

The issue of whether the Army should offset all or some portion of serviceable returns against demands is not new. We have previously questioned the Army Materiel Command's policy of setting limits on serviceable returns.⁵ In a 1980 report, we recommended, and the Army agreed, that all serviceable returns should be offset against demands. Our 1985 report showed, however, that despite our earlier recommendation, the Army Materiel Command was not offsetting all serviceable returns against demands and was using a maximum serviceable return rate of 20 percent. The Army Materiel Command, in commenting on our 1985 draft report, said that it had concluded that offsetting all serviceable returns against demands would adversely affect supply availability rates. In response to their comments, we pointed out that the basis for its

³The 254 demands occurred in the continental United States and European and Southwest Asian theaters. The offsets against demands are also determined on a theater-by-theater basis. Therefore, the 20 serviceable returns that were not used to reduce demands is the cumulative total for the three theaters.

⁴If an item receives 100 demands during a 1-year period and 60 of the items are returned to the wholesale level in serviceable condition, the demand base can be reduced by 50 percent even though 60 assets were returned.

⁵Army Can Save Millions Annually by Properly Considering Serviceable Returns in Its Requirements Computations (LCD-80-64, May 15, 1980) and The Army's Use of Serviceable Returns in Requirements Computations (GAO/NSIAD-85-69, Apr. 9, 1985).

conclusion was not substantiated by analysis and that our review showed that supply availability rates were not adversely affected.

The issue of offsetting serviceable returns against demands was raised again in June and October 1991 when the DOD Inspector General reported that the Army was not complying with the DOD policy, which requires that the offset of serviceable returns against demands be based on an item-by-item analysis.⁶ The reports recommended the Army comply with the policy. However, according to the reports, the Army did not provide comments regarding its intention to take action on the recommendations.

In commenting on a draft of this report, DOD officials said that the use of the 50-percent offset was based on the consideration of the extensive manual effort required to do an item-by-item analysis. They further stated that the Army is now reviewing its method of treating serviceable returns to ensure that an overstatement of requirements objective does not occur.

⁶Report on the Audit of Military Department Requirements for Currently Procured Wholesale Inventories of Consumable Items (Report No. 91-106, June 28, 1991).

Scope and Methodology

We discussed the current policies and regulations regarding the requirements determination process with officials in the Army's Deputy Chief of Staff for Logistics, the Army Materiel Command, Office of Secretary of Defense for Supply Management Policy, Tank-Automotive Command, Aviation Systems Command, and Army Missile Command. We analyzed budget stratification reports, individual item studies, and other requirements data to determine the overall trends of the changes in the requirements levels making up the AFAO.

Based on our analyses, we selected certain requirements levels for detailed analysis. More specifically, we reviewed

- war reserve requirements to determine whether the requirements reflect current Army doctrine and strategy,
- the basis for increasing the requirements objective to accommodate inventory items due in on contracts that have been determined as uneconomical to terminate (EXTRO),
- nonrecurring demands to determine whether they were included in the demand base used to forecast future needs, and
- how serviceable assets returned to the wholesale level are considered in determining future needs.

We also reviewed our prior reports and studies prepared by the Army's Inventory Research Office and the DOD-Inspector General.

We conducted our work during the period January through September 1992 in accordance with generally accepted government auditing standards.

Comments From the Department of Defense



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, DC 20301-8000

PRODUCTION AND
LOGISTICS
(L/MRM)

March 18, 1993

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "ARMY INVENTORY: Current Operating and War Reserve Requirements Can Be Reduced," dated February 5, 1993 (GAO Code 393489), OSD Case 9301. The DoD generally agrees with the report. Although Army inventory requirements have been reduced from \$37 billion to \$27.3 billion in the past three years, the DoD agrees that additional reductions can be made. Actions are underway in several key areas to implement such reductions. For example, the Army is now completing its review of war reserve requirements. Initial results indicate a significant reduction in war reserve requirements, from \$10.2 billion to \$4.2 billion. In addition, inclusion of nonrecurring demand in the demand data base is limited in the new DoD Materiel Management Regulation to the quantity that can be demonstrated to improve the demand forecast.

The DoD also agrees that action is required to ensure that the Army method of offsetting serviceable returns against demands should be improved to ensure that overstatement of the requirements does not occur. The Army is now reviewing its method of treating serviceable returns. In addition, the Army will issue guidance to its Inventory Control Points to review serviceable return rates on an item-by-item basis where experience shows economies can be gained.

The findings and recommendations are addressed in greater detail in the enclosure. The DoD appreciates the opportunity to comment on the draft report.

Sincerely,

Jeffrey A. Jones
Acting Deputy Assistant
Secretary (Logistics)

Enclosure

GAO DRAFT REPORT - DATED FEBRUARY 5, 1993
(GAO CODE 393489) OSD CASE 9301

"ARMY INVENTORY: CURRENT OPERATING AND WAR
RESERVE REQUIREMENTS CAN BE REDUCED"

DEPARTMENT OF DEFENSE COMMENTS

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FINDINGS

- **FINDING A: Army Efforts to Reduce the Current Operating and War Reserve Requirements For Secondary Items.** The GAO noted that the current Army operating and war reserve needs are referred to as the Authorized Force Acquisition Objective and represents the Army future needs during the next 24 to 36 months. The GAO observed that the objective consists of various requirements levels and costs as follows:
 - War Reserve--the number and value of inventory items needed to replace combat equipment losses after a war starts;
 - Demands--the value of the inventory that is forecasted as being needed during the period covered by the Authorized Force Acquisition Objective;
 - Safety level--the value of inventory that is needed to meet operational needs in the event of unanticipated delays in receiving ordered materiel or unanticipated increases in demands;
 - Administrative and production lead times--the value of inventory needed to meet operational needs from the time an order is initiated until the ordered items are received;
 - Repair cycle time--the value of inventory needed to meet operational needs during the time it takes to repair unserviceable items to meet forecasted requirements; and
 - Reorder cycle time--the value of inventory needed to meet the economic order quantity, i.e., the requirement level that optimizes the cost of holding inventory versus the cost of placing a procurement order.

The GAO reported that, over the past 3 years, the Army has reduced its requirements for spare parts needed to meet the Authorized Force Acquisition Objective--from \$37 billion to

ENCLOSURE

Now on p. 1 and pp.
12-13.

\$27.3 billion--from \$11.2 billion to \$9.3 billion at the Aviation Systems Command and from \$8.2 billion to \$5.2 billion at the Tank-Automotive Command. The GAO added that the reduction was the result of a conscious decision by the Army that with a changed threat environment and reduced force structure, less inventory would be required. (p. 1, pp. 14-17/GAO Draft Report)

DoD RESPONSE: Concur. As the GAO noted, the Army has achieved a substantial reduction in requirements over the past three years as the result of its response to the changed threat and reduced force structure. This reduction implements the DoD Inventory Reduction Plan, directed by the Under Secretary of Defense (Acquisition) in May 1990, to reduce inventory in recognition of the new global environment and budgetary realities.

- **FINDING B: War Reserve Requirements Are Overstated As a Result of Not Being Updated to Reflect Current World Conditions.** The GAO reported that, during the period March 1989 through June 1992, the requirements for funded war reserves at the Tank Automotive Command increased from \$264 million to \$470 million, and at the Aviation Systems Command from \$324 million to \$359 million. The GAO concluded that the increases occurred--in part--because the Army policy allowed the National Inventory Control Points to increase the funded war reserve requirements by transferring inventory assets that exceeded the amount needed to meet current operating and war reserve requirements to the funded portion of the war reserve requirement. The GAO further concluded that, by doing so, the Army could increase the requirements objective and protect inventory from possible disposal action.

The GAO also concluded that the overstated war reserve requirements and the resulting overstated requirements objectives resulted in unnecessary repair programs being established and could cause unneeded procurements to be made. The GAO found that at the Tank-Automotive Command, repair programs, costing about \$4 million, were established because of overstated war reserve requirements. The GAO noted that Tank-Automotive Command officials advised that the Army is in the process of revising war reserve requirements to reflect the current threat and force structure, which according to the Army, should be about 60 percent less than the current requirements. The GAO concluded that, as a result, the funded war reserve requirements at the Tank-Automotive Command and the Aviation Systems Command are currently overstated by at least \$500 million.

Now on pp. 2-3 and
15-16.

The GAO observed that, in addition to revising war reserve requirements to reflect the current need, the DoD issued instructions in September 1991, that directed the Services to include in the funded portion of the war reserve requirements only those items acquired with funds appropriated by the Congress for that purpose. The GAO explained that, at the time the review was completed in September 1992, the Tank-Automotive Command had not taken action to reduce the funded war reserve requirements by eliminating the items that had been previously transferred in from unneeded inventory. The GAO, therefore, concluded that while the funded portion may not increase in the future, the existing funded war reserve requirements are still overstated and could continue to influence repair program and procurement decisions. (pp. 3-4, pp. 18-20/GAO Draft Report)

DoD RESPONSE: Concur. At the time of the GAO audit work, the Army's war reserve requirements had not been recomputed to reflect the changing threat and force structure. Therefore, war reserve requirements were outdated. The Army is now completing the War Reserve Automated Process and evaluations by the Army Major Commands have begun. Initial results indicate a significant reduction in war reserve requirement levels, from \$10.2 billion to \$4.2 billion. Final evaluation results are expected by June 1993.

- **FINDING C: Items Due-In on Contracts Uneconomical to Terminate Are Causing Requirements Objectives To Be Overstated.** The GAO pointed out that Army policy allows the National Inventory Control Points to increase the requirements objectives to include inventory items procured through life-of-type and quantity discount situations--the item is going out of production. The GAO explained that the increased objectives are referred to as the Extended Requirements Objective. The GAO noted that the Army had expanded the use of the policy to include items due-in on contracts that have been determined as uneconomical to terminate or reduce. The GAO found that, as a result of including items due-in on contracts that the commands have determined as uneconomical to terminate or reduce, the requirements objectives were overstated at least \$21 million at the Tank-Automotive Command. The GAO concluded, however, that including items in the requirements objectives do not affect repair program or procurement decisions, because the requirements are reduced as the items are issued--and items not needed for current operating requirements are categorized as being needed.

The GAO also concluded a decision that it is uneconomical to terminate or reduce a contract is a defacto decision that it is

Now on pp. 3-4 and
17-18.

economical to retain the items. The GAO explained that is essentially the definition of economic retention inventory--inventory that is not needed to meet current operating and war reserve requirements, but is more economical to retain than to dispose of the items and reprocure them at a later date. The GAO concluded, therefore, that items due-in on contracts--which are uneconomical to terminate--should be considered as economic retention inventory. (pp. 4-6, pp. 21-24/GAO Draft Report)

DoD RESPONSE: Partially concur. The DoD agrees with the GAO observation that the Army includes in the Extended Requirements Objective items due-in that are uneconomical to terminate from contracts. However, the DoD does not agree that this results in overstating the requirements objectives, nor that such due-ins should be included in economic retention stock. The items in question are in a due-in status and not physically on-hand; therefore, they are not included in the authorized acquisition objective nor in economic retention stock. When an item included in the Extended Requirements Objective is actually received, it will be included in the appropriate level. For example, if the on-hand stocks are above the authorized acquisition objective, the items could be included in economic retention stock.

FINDING D: Overstated Demands Result in Overstated Requirements and the Potential For Unnecessary Procurements. The GAO reported that the demand data bases used to forecast requirements consists primarily of recurring demands--i.e., defined as repetitive requests for material. The GAO found that, during the period between July 1991 and June 1992, the Tank-Automotive Command and the Aviation Systems Command included nonrecurring demands valued at \$100 million and \$410 million, respectively, in the demand data bases. The GAO concluded that the nonrecurring demands equated to increased requirements of about \$200 million at the Automotive Command, and about \$819 million at the Aviation Systems Command. The GAO reported that, while all the National Inventory Control Points currently include nonrecurring demands in the demand data bases, it has not always been the case. The GAO pointed out that, until November 1991, the Missile Command did not include nonrecurring demands because, according to a Missile Command official, to do so would (1) inflate demand levels and (2) cause inaccuracies in requirements and the asset position for items not needed to meet operating and war reserve requirements.

The GAO questioned the rationale for including nonrecurring demands as part of the demand forecasting process. The GAO observed the following:

Now on pp. 4-5 and
19-21.

- the requirements determination process includes a safety level requirement to provide for instances where there are unanticipated demands--nonrecurring demands could be considered as unanticipated; and
- retail level activities are precluded by Army regulations from including nonrecurring demands in the requirements computations--however, because the wholesale level requirements are a reflection of retail level demands, it is inconsistent that the wholesale level would include nonrecurring demands in the requirements determination process.

The GAO asserted that the Army position is not supported by studies or analyses. The GAO pointed out that in September 1990, the Army Materiel Command questioned the policy of including nonrecurring demands in the demand data base. The GAO also pointed out the Command had advised the National Inventory Control Points that nonrecurring demands should be coded as such--because, otherwise, the demands would be counted as recurring demands and could result in unnecessary procurements by the wholesale system. (pp. 6-8, pp. 25-28/GAO Draft Report)

DoD RESPONSE: Concur. The DoD agrees that caution should be used before including nonrecurring demand in the demand data base. This DoD policy is implemented in DoD Materiel Management Regulation 4140.1-R, which provides that demand identified by customers as nonrecurring shall be included to the extent that the Integrated Materiel Manager can demonstrate that a particular quantity of nonrecurring demands will improve its demand forecast.

- **FINDING E: Requirements Are Overstated Because All Serviceable Returns Are Not Offset Against Demands.** The GAO reported that the Tank-Automotive Command and the Aviation Systems Command do not perform an item-by-item analysis to determine whether to offset the demand data by the serviceable return. The GAO found that, instead, the Commands use an offset limit equal to 50 percent of demands as the basis for adjusting the demand data bases. The GAO explained that, according to Command officials, systemic deficiencies in the data systems preclude managing serviceable returns on an item-by-item basis. The GAO concluded that, because the item managers cannot relate the return of a specific serviceable asset to the specific demand, the managers cannot determine whether the return should be offset against demands. The GAO selected 15 items at the Tank-Automotive Command and performed an item-by-item analysis. The GAO found

Now on pp. 5-6 and 21-23.

that the 15 items had 1,416 serviceable returns, valued at \$2.6 million--which were not offset against demands because the number of returns exceeded the 50 percent of demands offset limit.

In summary, the GAO concluded that, despite the GAO and the DoD Inspector General having previously questioned the Army practice of not adjusting the demand base to reflect all serviceable returns, the Army continues to use an offset limit based on a percentage of demands--rather than performing an item-by-item analysis. (pp. 8-9, pp. 28-32/GAO Draft Report)

DoD RESPONSE: Concur. The Army method of offsetting serviceable returns against demands was revalidated in findings of a 1985 study, and later adjusted to reflect experience. Principal considerations in the development of the 50 percent offset level included the considerable manual effort required in performing a item-by-item analysis and the fact that not all returns categorized as serviceable are determined to be serviceable upon receipt at the wholesale depot.

* * * * *

RECOMMENDATIONS

- **RECOMMENDATION 1:** The GAO recommended that the Secretary of the Army direct the Commander, Army Materiel Command, to establish war reserve requirements based on the latest Army strategy and doctrine giving consideration to (a) the new threat, (b) the reduced force structure, and (c) the probable type of conflicts the Army can expect in the future. (p. 9/GAO Draft Report)

Now on p. 6.

DoD RESPONSE: Concur. As discussed in the DoD response to Finding B, the Army has already taken action to adjust war reserve requirements. The Army is now completing the War Reserve Automated Process and evaluations by the Major Commands have begun. The estimated completion date is June 1993. Initial results indicate a significant reduction in war reserve requirement levels, from \$10.2 billion to \$4.2 billion.

- **RECOMMENDATION 2:** The GAO recommended that the Secretary of the Army direct the Commander, Army Materiel Command, to transfer to retention level inventory or send to disposal, that inventory that is no longer needed to meet the revised war reserve requirements. (p. 9/GAO Draft Report)

Now on p. 6.

Now on p. 6.

DoD RESPONSE: Concur. The GAO recommendation reflects established DoD policy. It is estimated that by June 1993, the Army will complete its evaluation of war reserve requirements and potential reductions. With the reduced war reserve requirements, on-hand inventory not categorized as authorized acquisition objective, economic retention, or contingency retention, will be categorized potential reutilization/disposal.

- **RECOMMENDATION 3:** The GAO recommended that the Secretary of the Army direct the Commander, Army Materiel Command, to re-categorize as economic retention level inventory those items that are being retained as part of the requirements objective because the associated contracts are uneconomical to terminate. The GAO further recommended that, for those inventory items that do not qualify for economic retention, the action be taken to process the items for disposal. (pp. 9-10/GAO Draft Report)

DoD RESPONSE: Partially concur. As discussed in the DoD response to Finding C, the DoD does not agree with the GAO proposal to categorize due-in items as economic retention stock. It is the DoD policy that items that are due-in are not part of the inventory. Economic retention stock refers to items that are physically on-hand. The DoD agrees that on-hand items that are not within the approved acquisition objective, economic retention stock, or contingency retention stock should be categorized as potential reutilization/excess stock. As discussed in the DoD response to Recommendation 2, appropriate adjustments will be made once the ongoing Army evaluation is completed in June 1993.

Now on p. 7.

- **RECOMMENDATION 4:** The GAO recommended that the Secretary of the Army direct the Commander, Army Materiel Command, to discontinue the practice of including nonrecurring demands as part of the demand data base used to forecast spare parts requirements. (pp. 9-10/GAO Draft Report)

DoD RESPONSE: Concur. As discussed in the DoD response to Finding D, the DoD agrees that caution should be used in including nonrecurring demands as part of the demand data base used to forecast requirements for secondary items. That DoD policy is outlined in the new DoD Materiel Management Regulation DoD 4140.1-R, issued January 1993. The policy requires that demand identified by customers as nonrecurring shall be included to the extent that the Integrated Materiel Manager can demonstrate that a particular quantity of nonrecurring demands will improve its demand forecasts.

Now on p. 7.

- **RECOMMENDATION 5:** The GAO recommended that the Secretary of the Army direct the Commander, Army Materiel Command, to begin offsetting all serviceable returns against demands unless an item by item analysis shows that there are systemic deficiencies which preclude serviceable returns from being offset against demands. The GAO further recommended that, in such cases, the National Inventory Control Point should identify the systemic deficiencies and develop a corrective action plan for resolving the deficiencies. (p. 10/GAO Draft Report)

DoD RESPONSE: Concur. As discussed in the DoD response to Finding E, the current Army approach to offsetting serviceable returns against demands was revalidated by the results of a 1985 study, and later adjusted to reflect experience. Primary considerations in the development of the current 50 percent offset rate were the extensive manual effort involved in performing item-by-item analyses and the fact that not all returns originally categorized as serviceable were considered serviceable upon receipt at the wholesale depot.

The DoD agrees that action is required to ensure that the Army method of offsetting serviceable returns against demands should be improved to ensure that overstatement of the requirements objective does not occur. The Army is now reviewing its current method of treating serviceable returns and will implement the results of this review by June 1994. Furthermore, by June 1993, the Army will issue guidance to its National Inventory Control Points to review serviceable return rates on an item-by-item basis where experience shows economies can be obtained.

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